



## RISK MANAGEMENT:

What you need to know about life insurance - dispelling the public misconceptions!

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Recently, I had finished teaching a course called Risk Management and Life Insurance. This course leads graduates to earn a Bachelors in Financial Services and enables them upon completion to write the Certified Financial Planning qualifying exam. When the topic of life insurances comes up both in the financial planning community and the general public there arise several misconceptions. These misconceptions unfortunately can result in inadequate coverage and unnecessary financial hardship for families who suffer the loss of a loved one.

It has often been said that there are only two certainties in life (Canada), death and taxes! During my career as a Certified Financial Planner, I have rarely met anyone who bought life insurance and then found any enjoyment from spending their hard earned money on paying the premiums. However, over the last decade I have never heard of a life insurance beneficiary say after making a claim that their dearly departed had bought too much life insurance.

The reasons an individual purchases life insurance arise from their basic desire/need to protect someone or something financially in the event of their premature death. For most people, not owning life insurance at death would otherwise leave outstanding unfulfilled financial obligations, such as not

having enough funds to support dependents, educate their children, and pay taxes or mortgages. In essence, one buys life insurance because they either love someone or they owe someone.

In my financial planning classes and professional career the question that often arises is "What steps should Canadian Consumers embrace when considering buying life insurance?" My stock reply is that Canadian Consumers should apply the Six Step Life Insurance Needs Process, this process determines if there is first a need for insurance, and if there is, it allows for them to decide how much life insurance to buy so they will mitigate their financial risk.

### The Six Step Life Insurance Need Process

#### *Step 1: Determine whether you need life insurance.*

The primary reason for purchasing life insurance is to protect those who are dependent on your income. For example if you are the owner of your own business and you die prematurely, you might need insurance to contribute to the company's cash flow to replace yourself as a contributing member to the bottom line. Or if you are married with children, by having the proper amount of insurance your family will receive enough money to replace you as the breadwinner of your family. Some of your

needs for life insurance coverage might be temporary in nature such as paying for your children to go to university or to pay off the mortgage. If you have accumulated a lot of assets in this lifetime, you may need life insurance to pay taxes after your death on your estate.

It is a major misconception that only the family breadwinner needs life insurance. Although the stay-at-home parent may not contribute cash income to the family, he or she provides important services, such as caring for the children and keeping up the home, which would be costly to replace, therefore insurance is also required on the stay-at-home parent.

On the other hand, if you are young and single, with no children and no aging parents, chances are, you don't need life insurance. Understandably, some single people want life insurance for covering funeral expenses, paying off accumulated debt, or making bequests to charities or special individuals. However, this is the exception rather than the rule.

*Step 2: Estimate the amount of life insurance you need.*

Life insurance needs vary from individual to individual and can even vary throughout your lifetime. Determining the right amount takes homework.

In this step of the process a life insurance needs analysis is completed. You need to inventory all your other financial resources and think long and hard about how much it would take for your family to maintain its lifestyle without you. A balance sheet is created, which adds up all your life insurance policies and other financial and material assets, then subtracted from that amount are all your financial liabilities. A person's liabilities don't just include their mortgage and credit card debt but also the loss of their human value.

Human value is calculated based on the present value of one's contribution to their family's income and lifestyle, today and in the future. For example an individual who earns \$100,000 today, their family may require 60% of their gross income to meet current and future financial obligations. To calculate the life insurance needs of a stay-at-home parent, determine how much it would cost each year to pay someone to provide those same services for as long as your family would need them.

The difference between a person's assets,

liabilities and their human value, is the amount of new life insurance that should be purchased/owned. If you own life insurance and your agent has not done this step in The Six Step Life Insurance Need Process, most likely you own the wrong policy and have the wrong amount of insurance coverage.

*Step 3: Decide the best type of insurance for you.*

The next step in the process is to decide what type of insurance best suits your individual situation. The best policy is the one that best meets your financial needs. If the amount of money you can spend on life insurance is limited, or if you have a temporary need, consider only term insurance. If you need lifetime protection, consider permanent life.

Term life insurance is "pure" insurance with no investment component. You buy term insurance for the duration of time you will need coverage. Your premiums typically go up each year unless you opt for a level premium term policy. The premiums for this type of policy are higher but remain constant for the term of the policy.

While the primary reason for any life insurance purchase should be income protection for your family, permanent insurance policies, including whole life, universal life, or variable life provide long-term, investment-like features that some people find appealing. For example, with these policies you can build a cash accumulation value from which you can withdraw during your lifetime, though doing so may affect your

death benefit and have tax consequences. If you're looking for pure return on capital, other investments usually provide better results. Remember insurance is exactly that, it is insurance, it should never be bought for the primary purpose of investments. Keep in mind, too, that the premiums on these policies are higher than on term insurance policies.

Note: At all cost avoid purchasing a life insurance policy that you can not afford. 20% of life insurance policies lapse for non payment of premiums during the first year.

*Step 4: Shop around for a low cost policy.*

How much you pay for life insurance will depend on a number of risk factors, including your health, your age, your family's medical history, and the type and amount of insurance you are looking to purchase. Each insurance company has different



cost structures for their term, permanent and universal life insurance products. Although life insurance products are becoming more commodity-like and insurance companies are continuing to lower premiums to remain competitive, there are still price variables. Shopping around for low-cost life insurance policies can save you thousands of dollars during the lifetime of a policy.

*Step 5: Consider the Financial strength of the Insurance Company.*

Do you remember Confederated Life, this was an insurance company that was founded before the Confederation of Canada in 1867, which went bankrupt several years ago. Yes, insurance companies do have the potential to go bankrupt. Although, there is the Canadian Life and Health Insurance Compensation Corporation (CompCorp), founded in 1990 to protect Canadian policyholders against loss of benefits or unpaid claims under their life insurance contracts, should a CompCorp insurance company member collapse. However, it should be noted that CompCorp does not receive any financial support from the federal or provincial

governments and it is a voluntary organization. Thus there is no guarantee that either CompCorp or the insurance company the life insurance will be able to pay the death benefit. Therefore, it is important to buy life insurance only from financially sound insurance companies. There are a number of rating organizations that periodically grade the strength of these companies. It is important to know how your life insurance company rates.

*Step 6: Deal with a Competent Certified Financial Planner (CFP) or Chartered Life Underwriters (CLU)*

To receive the right advice and to be sold the right policy, you should consider your agent's experience and professional qualifications. Certified Financial Planners (CFP) and Chartered Life Underwriters (CLU) are technically competent in the area of Life Insurance. These individuals who have attained either the CFP or CLU designations must continually meet education, examination, experience and ethical standards. A CFP or CLU familiar with your overall financial situation can provide you with useful advice concerning what type and how

much life insurance you should own.

One last thing, as our life changes, so do our needs with the amount of life insurance we should own. Thus it is important as a rule of thumb to sit down with your CFP or CLU every year to take you through the Six Step Life Insurance Need Process to make sure you have the proper amount of coverage that best suits your life circumstances now and in the future.

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